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Essay

Asymmetric Rewards: Why Class Actions (May) Settle for Too Little

by
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I. Introduction

The topic of this essay is the principal-agent problem in class action settlements. More precisely, it examines the danger that class counsel may settle the claims of the class members for "too little," that is, for less than their expected value at trial. My central claim is that this danger is a function of the structure of the fee awarded class counsel in the event of settlement, and that the danger can be substantially alleviated through appropriate judicial regulation of the fee.

The risk that class counsel may in effect "sell out" the class members in the settlement has long been a source of concern among courts and commentators, and has become particularly pronounced as the class action device has been used with increasing frequency in damages actions.[1] In recent years, large-scale class action settlements in mass tort and other cases have brought forth charges that the class members were in effect paid only pennies on the dollar, with judicial

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1. For some early expressions of concern, see Judge Friendly's cautionary remarks in Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (dissenting opinion), and in Saylor v. Lindsley, 456 F.2d 896, 900 (2d Cir. 1972), and the insightful observations in Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. LEGAL STUD. 47, 57-59 (1975). More recent systematic treatments of the problem include John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

approval of the settlement.[2] The *Georgine* asbestos case, now pending before the Supreme Court,[3] is probably the best-publicized, though hardly the only, recent case in which such charges have been leveled.[4]

As a result of these concerns, critics have argued for the sharp curtailment of the class action device, out of concern that collusive settlements between class counsel and the defendant are simply a built-in problem that cannot be fixed except by scrapping the use of the class action in certain settings.[5] In essence, the argument is that class members cannot effectively protect themselves against having their claims settled for too little. In addition, judicial monitoring of the terms of settlement is not an effective safeguard against the problem. As a result, class counsel face irresistible temptations to settle class members' claims for less than they are worth.

These concerns have most recently crystallized in the debate over the so-called "settlement class action," a procedural device by which courts simultaneously certify a class and approve a class-wide settlement. The *Georgine* case presents the question of whether (and under what circumstances) the use of this device is permitted by existing law. At the same time, amendments to the Federal Rules of Civil Proce-

2. *See, e.g.*, John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343 (1995); John C. Coffee, Jr. & Susan P. Koniak, *Rule of Law: The Latest Class Actions Scam*, WALL ST. J., Dec. 22, 1995, at A11; Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 VA. L. REV. 1051 (1996); Barry Meier, *Fistfuls of Coupons: Millions for Class-Action Lawyers, Scrip for Plaintiffs*, N.Y. TIMES, May 26, 1995, at D1; Richard B. Schmitt, *The Dealmakers: Some Firms Embrace the Widely Dreaded Class-Action Lawsuit*, WALL ST. J., July 18, 1996, at A1; Richard B. Schmitt, *Behind Apple's Class Action Settlement*, WALL ST. J., Dec. 4, 1996, at B1; Nancy Morawetz, *Bargaining, Class Representation, and Fairness*, 54 OHIO ST. L.J. 1, 5-7 (1993).

3. Georgine v. Amchem Prods., Inc., 83 F.3d 610 (3rd Cir. 1996), *cert. granted sub nom.*, Amchem Prods., Inc. v. Windsor, 117 S. Ct. 379 (1996).

4. *Georgine*, a "settlement class action" that would resolve perhaps a million or more future claims for asbestos-related disease, has been singled out for extensive criticism for its alleged collusiveness. Many of the articles in a recent symposium on mass torts (volume 80, number 4 of the Cornell Law Review (May 1995)) raised this concern about *Georgine*; see in particular Susan P. Koniak, *Feasting While the Widow Weeps: Georgine v. Amchem Products, Inc.*, 80 CORNELL L. REV. 1045 (1995). *See also* Coffee, *supra* note 2.

5. For example, critics have argued that "settlement class actions" (in which a class is certified for settlement purposes only) and class actions involving future claims (where the victims may not yet know who they are) have been too eagerly embraced by courts, without adequate safeguards to protect against principal-agent problems. *See, e.g.*, James A. Henderson, *Settlement Class Actions and the Limits of Adjudication*, 80 CORNELL L. REV. 1014 (1995); Coffee & Koniak, *supra* note 2; Coffee, *supra* note 2. A proposal—now pending before the Standing Committee on Rules of Practice and Procedure—to amend FRCP 23 to permit settlement class actions has been publicly opposed by a distinguished group of law professors on this among other grounds. *See* Letter from Steering Committee to Oppose Proposed Rule 23 (June 1, 1996) (on file with the author).

dure have been proposed that would expressly authorize use of the device.[6] Opponents of the device argue that the risk of having the class members "sold out" in settlement is particularly acute with this device, because the defendant can in effect solicit competing bids from different plaintiffs' lawyers.[7] The concern about collusive settlements is hardly confined to the settlement class action device; observers have long worried that even in ordinary trial class actions, there is a built-in pressure to settle for too little. Use of the settlement class action, it is argued, only aggravates this tendency.

My claim in this essay is that excessively low settlement amounts are not a necessary or inherent feature of the class action (either settlement class actions or ordinary trial class actions), but rather the product of attorney incentives that can be adjusted to reduce if not eliminate the risk entirely. I do not dispute that class members are frequently unable to protect themselves (by vetoing or opting out of the settlement) or that judges, lacking information about the value of the class members' claims, are frequently unable to police the terms of settlement in such a way as to prevent claims from being settled for too little. I take these problems to be fixed properties of the class action in many settings. As a result, absent appropriate judicial regulation of the fee collected by class counsel in settlements, there is in principle an enormous risk that class counsel will settle the case for too little—perhaps far too little. But this is only because class counsels' rewards have not been appropriately structured. I argue that the defect in the reward structure is comparatively simple to identify, and (within limits) possible to remedy—even though class members have no way of protecting themselves, and even though courts may have little idea of what the class members' claims are worth.

The incentive problem arises from an asymmetry or inequality between (1) class counsel's effective share of a settlement he negotiates, and (2) his effective share of what the class members would receive if he did not negotiate a class settlement. Such an asymmetry encourages him to settle the case for less than it is worth to the class. If courts are not attentive to this problem, the asymmetry in class counsel's rewards and the resulting distortion in his incentives may be quite substantial: one can imagine seemingly plausible scenarios in which an asymmetry of an order of magnitude or even several orders of magnitude may exist, so that class counsel has an incentive to settle

6. *See* Proposed Rules, *Proposed Amendments to the Federal Rules of Civil Procedure: Rule 23, Class Actions*, 167 F.R.D. 559 (1996).

7. *See, e.g.*, sources cited *supra* note 1.

the case for a minuscule fraction of its value to the class. The court's task in structuring class counsel's fee is to make symmetric the rewards from settling and not settling and so eliminate this distortion in incentives.

The need for policing class counsel's fee in settlement is hardly news to the judiciary. Courts have always recognized that leaving counsel's fee unregulated would invite settlements in which counsel is paid handsomely at the (unjustified) expense of the class members.[8] To guard against this danger, courts police the "reasonableness" of the class counsel's fee in settlement. In doing so, however, courts tend to ask the wrong question: they focus on the counsel's "take" from the settlement in absolute terms, rather than focusing on his "take" relative to what he would have gotten if the case had gone to trial. This misplaced focus can be potentially quite costly. A fee award that appears to be reasonable in absolute terms may be quite excessive in relative terms, giving the class counsel an incentive to settle for too little.

In particular, a fee award amounting to twenty percent (the benchmark widely employed by courts)[9] or even five or ten percent may lead to an enormously insufficient recovery by the class. The reason is not—contrary to what some critics have said—that a fee percentage in this range gives the lawyer a "windfall" (excessive recovery) or gives the class an unfairly small ex post distributive share of the recovery.[10] My argument has nothing to do with lawyer profits or distributional fairness in dividing up the settlement. The problem, rather, is that such a percentage may have the effect, ex ante, of encouraging the lawyer to agree to a settlement in the first place that is far smaller than what would be recovered (in expected terms) at trial. The upshot is that the "pie" will be too small, and the class will re-

8. *See, e.g., In re* General Motors Corp. Pick-Up Truck Fuel Tank Prods. Liab. Litig., 55 F.3d 768, 800-05 (3d Cir. 1995) (collecting authorities).

9. A number of studies have shown that fee awards in class action settlements tend to be in this range. *See, e.g.*, William J. Lynk, *The Courts and the Plaintiffs' Bar: Awarding the Attorney's Fee in Class-Action Litigation*, 23 J. LEGAL STUD. 185, 208 (1994); HERBERT B. NEWBERG & ALBA CONTE, ATTORNEY FEE AWARDS 50-53 (2d ed. 1993); Report of the Third Circuit Task Force, *Court Awarded Attorney Fees*, 108 F.R.D. 237, 247 n.32 (1985).

10. In high-stakes cases, awarding this percentage (or even less) has sometimes meant giving the class counsel many millions of dollars. This has prompted extensive criticism in the press, in academia, and in the legal profession, on the grounds that lawyers were collecting fees disproportionate to their efforts in the case and taking money that properly belonged to the class members. Instances of such criticism are recounted in NEWBERG & CONTE, *supra* note 9, at 32, and Report of the Third Circuit Task Force, *supra* note 9, at 242. *See also* ARTHUR R. MILLER, ATTORNEYS' FEES IN CLASS ACTIONS: A REPORT TO THE FEDERAL JUDICIAL CENTER 300-01 (1980) (quoting criticism of lawyer "windfalls").

cover too little. This may happen even if a fee in the twenty percent range seems to give the lawyer a fair distributive share of the "pie."

The reason, quite simply, is that such a percentage may substantially exceed the fraction of the class members' recovery that the attorney would have received had there been no class-wide settlement. This is most obviously true in the context of class actions certified for purposes of settlement only: had there been no class settlement, no single lawyer would have represented more than perhaps a tiny fraction of the plaintiffs in the class.[11] In such a setting, a fee award in the range of twenty percent may be too large by a factor of 100 or more. This problem is not, however, confined to the context of settlement class actions; it may also arise in the settlement of conventional class actions that have been (or will be) certified for purposes of trial.[12] Fee awards that are unobjectionable in distributional terms may have disastrous incentive properties, with tragic results for the class members.

In developing this analysis, I build on previous work that has shown that the prevailing methods for calculating the class counsel's fee—paying him either an hourly rate or a percentage of the recovery—may lead the counsel to settle for less than the class's claims are worth.[13] I incorporate these insights into a more general framework for identifying and removing distortions in the class counsel's incentives. Application of the framework yields greater potential optimism, but also greater potential pessimism, than is warranted by previous analyses of the problem. On the one hand, it offers a relatively simple prescription for correcting distorted counsel incentives; the prescription can hardly be expected to work perfectly, but it may substantially reduce any structural tendency for class action claims to settle for less than they are worth to the class. On the other hand, if the prescription is ignored, my analysis suggests that the problem of distorted counsel incentives may be much worse than has been previously recognized.

The intended contribution of this essay, therefore, is three-fold. (1) It demonstrates the importance of equalizing class counsel's fractional share of a settlement he negotiates and the fractional share he would get of the class's recovery if he did not negotiate a class settle-

11. *See infra* text accompanying notes 16-19.

12. *See infra* text accompanying notes 20-22.

13. On the problems posed by the hourly fee, see for example Coffee, *supra* note 1, at 717-18. *See also infra* text accompanying notes 47-51. On the problems posed by the percentage fee, see, for example, Dam, *supra* note 1, at 57; Macey & Miller, *supra* note 1, at 25; see also *infra* text accompanying notes 52-54.

ment. (2) It shows that an asymmetry in class counsel's relative shares may easily arise if courts are not attentive to the problem of setting class counsel's fee. Put otherwise, a fee structure that on its face appears quite reasonable may in fact create an enormous distortion of the class counsel's incentives. (3) It shows that the problem of asymmetric shares may, within limits, be remedied even in situations where the court does not know the value of the class's claims. That is, it is possible to structure the fee in such a way as to induce class counsel to settle for the full value of the class's claims, even though the court would not be able to detect a settlement that gave the class less than the value of its claims.

My purpose here is to suggest a method of improving the performance of the class action settlement process.[14] As such, the essay is meant to have a practical orientation with applications to a real-world problem. The essay is, however, a work of legal and economic theory, relying for its main conclusions on an analysis of the internal logic of class action settlements, rather than an examination of empirical data or case studies. Accordingly, I make no claims about whether, in any actual case in the past, the fee was correctly calculated or the class members received less than the value of their claims. This essay should be understood not as an examination or assessment of existing practices, but rather as an attempt to offer a new way of thinking about the structure of fee awards in class action settlements.[15]

Part II of this essay provides a simple overview of the analysis, furnishing the intuitive explanation for most of the conclusions I draw. Part III briefly sets forth my analytical framework for discussing the problem of asymmetric shares. Part IV examines how the class counsel's settlement incentives depend on the share he will get of the settlement he negotiates, in comparison to his share of what the class would get if he did not negotiate a class settlement. Part V turns to the question of why in practice class counsel may face asymmetric re-

14. In doing so, I remain within the existing structural framework of class action governance. I thus put to one side proposed alternatives to the class action, such as an auction procedure in which attorneys (or other interested bidders) could purchase the claims of the class members. For an argument in favor of such a procedure as a means of solving the principal-agent problem in class actions, see Jonathan R. Macey & Geoffrey P. Miller, *A Market Approach to Tort Reform via Rule 23*, 80 CORNELL L. REV. 909 (1995); Macey & Miller, *supra* note 1, at 105-16.

15. Some of the points in this essay are derived formally in Bruce L. Hay, *The Theory of Fee Regulation in Class Action Settlements* (July 1996) (unpublished manuscript), which examines a number of issues not touched upon in the present essay.

wards in settling the case. Part VI examines how the courts should structure class counsel's fee so as to make his rewards symmetric in the settlement context.

II. Overview: The Problem Of Asymmetric Shares

A. Nature of the Problem

The potential agency problem in class action settlements is simply stated. If the class counsel negotiates a class-wide settlement, he gets a larger fractional share of the class's recovery than he would if he did not negotiate a class-wide settlement. Anytime the counsel's rewards are asymmetric in this way, the class counsel will have an incentive to agree to a settlement that gives the class members less than the value of their claims.

For example, suppose that a given lawyer (or law firm) is representing a class of 1,000 plaintiffs in settlement negotiations. We will call the lawyer "class counsel." He may serve in this capacity for purposes of both settlement and trial (if a trial class action is involved), or for purposes of settlement only (if the class is to be certified for settlement alone). If the case went to trial, the plaintiffs would in the aggregate recover, in expected terms, $100 million. And let us say that class counsel would recover, in expected terms, profits of $5 million. Then class counsel's net recovery at trial would be five percent of the class's recovery. Suppose, however, that class counsel is entitled to collect a profit equal to ten percent of any amount recovered by the class in settlement.

It is easy to see that, given these differential rewards for settling and going to trial, class counsel will be willing to agree to a settlement that gives the class less than $100 million. Class counsel will agree to any settlement that gives him at least $5 million. If he gets ten percent of any settlement award to the class, he will be prepared to settle the case for $50 million[16]—much less than the class would have gotten, in expected terms, had the case gone to trial.

This distortion arises any time class counsel's share of a settlement is greater than his share of a trial award. The greater the gap between those two percentages, the greater the distortion becomes. In this example, if class counsel gets twenty percent of any settlement

16. Here we assume that the costs of settling (including the amount of time spent that could be devoted to other endeavors) are no greater than the costs of going to trial. The numbers would change somewhat, although the qualitative point would still hold, if we dropped this assumption.

amount (but only five percent of any trial award), he will be prepared to settle the case for $25 million. If he gets fifty percent of any settlement amount, he will settle for $10 million, and so forth.

B. Sources of Asymmetry

Why might class counsel's incentives be distorted in this way? There are two basic reasons that his share of a settlement he negotiates may be disproportionately high, leading him to settle the case for too little.

(1) Disproportionate Per-Claim Fees

The first reason is that the court may award the counsel a higher effective (or net) share *of each claim* if he negotiates a class settlement than he would get otherwise. For example, suppose that class counsel will get ten percent of the recovery on each claim if he negotiates a class settlement, and five percent if he does not. All else being equal, class counsel's effective share of the class recovery is greater if he negotiates a class settlement than if he does not.

It is unlikely that a court would do this intentionally, of course, but it might do so inadvertently.[17] Suppose, for example, that the court does not award fees based on an explicit percentage-of-the-award basis; instead, it pays an hourly rate. It may be that the court's method of calculating the hourly fee has the effect of giving the lawyer a greater fraction of a settlement he negotiates than he would get otherwise. When this occurs, the lawyer will settle the case for less than the claims are worth to the class.

(2) Disproportionate Client Bases

A second, independent reason is that class counsel's *client base* may be greater in settlement than it is at trial. This problem has received little attention, but it has enormous potential importance, as we shall see. Suppose, for example, that if the case goes to trial, class counsel would represent—and collect a fee from—only half of the plaintiffs in the class. (This might occur if the class has not been certi-

17. An empirical study conducted in the 1970s revealed that, on average, class action settlements gave the attorney a greater share of the proceeds than class actions that went to trial. *See* Andrew Rosenfield, *An Empirical Test of Class-Action Settlement*, 5 J. LEGAL STUDIES 113, 116 (1976). In a study of 104 class actions, the study found that in cases that went to trial, the attorney earned an average fee equal to 17% of the class's recovery; in cases that settled, the attorney earned an average of 17% *plus* $104,000. (Note that the attorneys who settled probably incurred lower costs, though this question was not examined in the study.)

fied for purposes of trial.) Suppose, however, that in negotiating a class-wide settlement, the class counsel represents all of the plaintiffs. In this situation, the counsel's effective share of the settlement amount is twice his effective share of the amount recovered at trial—even if the court awards equal percentages for either settlement or trial.[18]

This scenario may seem unlikely, but it is not. In mass tort cases, the so-called "settlement class action" has been used with increasing frequency in recent years. In such cases, the class is not certified for trial. So if the case does go to trial, different plaintiffs would be represented by different lawyers, and no single lawyer (or firm) would represent more than perhaps a small fraction of the overall class of plaintiffs.[19]

C. The Importance of Making Rewards Symmetric

If the court wants to prevent class counsel from settling for less than the value of the class's claims, it must ensure that his share of a settlement he negotiates is no greater than his share of what the class receives if he does not negotiate a settlement. This is true, I must emphasize, whether or not the court's method of calculating the fee is a simple percentage-of-the-award formula. Even if the court uses some other method, the class counsel's incentives will be determined by the *effective* share of a settlement he gets as a result of the court's fee calculation method. In addition, it makes no difference whether the fee is deducted from the class's (gross) recovery or is instead paid by the defendant. The court must ensure that class counsel's fractional share of what the class members get in settlement is no greater than his fractional share of what they would have gotten at trial.

The cost of failing to eliminate such an asymmetry in shares can be described quite simply: if the counsel's share of a settlement he negotiates is too large by a given factor, then the amount for which he is willing to settle the case will be too small by that same factor. Thus,

18. For example, assume that the effective per-claim fee percentage at trial or in settlement is 10%. If the case goes to trial, the class counsel will get only 5% of the class's recovery (that is, 10% of half of the class's recovery). In contrast, if he negotiates a settlement, he gets 10% of the class's recovery.

19. The problem does not simply arise in settlement class actions, however. Even in conventional trial class actions, there may be uncertainty over who will serve as class counsel at trial. This may happen, for example, when class actions are simultaneously filed in separate states. In such situations, no lawyer's *expected share* of the clients is 100%, because there is a possibility that someone else will serve as class counsel.

if his share of the settlement is twice as large as it should be, he will settle the case for half of the value of the class's claims, and so forth.

To illustrate the importance of eliminating asymmetric rewards from settlement, let me give a simple example. As noted above, one source of asymmetry arises when class counsel has a greater client base if he negotiates a class settlement than if he does not. Consider the following two hypothetical cases, which are identical in all respects except for the class counsel's client base if there is no class settlement:

> *Case (a)*: In the event there is no class settlement, class counsel will represent 100 percent of the class,[20] and will earn a profit (fee net of costs) equal to five percent of the recovery on each claim.
>
> *Case (b)*: In the event there is no class settlement, class counsel will represent only 1/50 of the clients in the ensuing litigation,[21] and will earn a profit equal to five percent of the recovery on each claim.

Suppose that class counsel negotiates a class settlement in each case. In case (*a*), his fee should give him a profit of no more than five percent of the settlement amount received by the class. In case (*b*), his fee should give him a profit of only 1/50 of that figure—that is, a profit of no more than 0.1 percent of the settlement amount.

If the court awards class counsel more than that, he will settle the class's claims for less than they are worth. Suppose, for example, that (contrary to our prescription) the court awards class counsel a fee that, in net terms, gives him five percent of the settlement amount in both cases. In case (*b*), this fee is too large by a factor of 50. As a result, the class counsel will be prepared to agree to a settlement that is too small by a factor of 50. Thus, if the class's claims are worth $100 million, class counsel may be willing to settle the entire case—extinguishing all claims—for as low as a paltry $2 million![22]

The reason that the class members are at such risk of being "sold out" in this example is that (in case (*b*)) class counsel has so little stake in their claims if there is no class settlement. He has no relation with most of the members of the class, in the sense that he gets no part

20. If there is no class settlement, there will be a class trial in which class counsel continues to represent the class.

21. Each client in the class will have his claim resolved separately, and class counsel represents only 1/50 of them.

22. Under such a settlement, counsel will get a profit of $100,000. If he goes to trial, he will get a profit of .05 × 1/50 × $100 million = $100,000. All else being equal, he will be willing to accept the settlement.

The court might disallow such a small settlement, depending on the court's ability to evaluate the strength of the plaintiff's claims. The critical point for present purposes is that this small settlement will be acceptable to the person who purports to represent the plaintiffs' interests.

of their award if there is no class settlement. So he, in effect, will be willing to settle their claims for a pittance (since he has practically nothing to lose by doing so). To counteract this tendency, the court must make his fee equal to only a tiny fraction of the amount paid in settlement. This will encourage class counsel to hold out for a relatively large settlement.

D. Comparison to Existing Methods of Fee Regulation

The approach suggested here, then, would require the court to assess the effective fractional share of the class members' recovery the class counsel would have gotten had there been no class settlement. Having assessed this fraction, the court's task is to ensure that counsel's effective fractional share of the class's recovery is no greater than that first fraction. To clarify the point, it will be helpful to contrast this approach with prevailing methods of policing the counsel's fee award.

Courts use two basic methods to test the "reasonableness" of a proposed fee award to class counsel for negotiating a class settlement.[23] The first is to examine the counsel's fee in relation to the amount of work he did (the time he spent) on the case. Courts disallow proposed fees that, in their view, give the counsel an excessive return on their investment in the case.[24] The second method is to examine the counsel's fee in relation to the class's recovery in the settlement. Courts disallow proposed fees that, in their view, give counsel an excessive distributive share of the total amount paid by the defendant to settle the case.[25] How well do these methods track the approach urged in this essay?

23. For general discussions of fee calculation methods in class actions involving monetary relief, see NEWBURG & CONTE, *supra* note 9, at § 2.

24. For one of many recent examples, see Rosenbaum v. MacAllister, 64 F.3d 1439, 1447-48 (10th Cir. 1995) (disallowing proposed fee award that would exceed $900 for every hour of work performed by lawyers and paralegals); Ellis v. Flying Tiger Corp., 504 F.2d 1004 (7th Cir. 1972) (holding that the trial court abused its discretion in awarding $600,000 in attorney's fees in approving a class action settlement, and reducing amount to $75,000). *See also In re* Oracle Sec. Litig., 131 F.R.D. 688 (N.D. Cal. 1990) (using a bidding system to ensure that class action attorneys do not receive excess profits). Perceived lawyer windfalls (in the sense of excessive hourly earnings) are a staple source of criticism of class action settlements. *See, e.g.*, Bradley A. Smith & Jeffrey N. Lindemann, *Legal Billing: Is the Meter Broken?*, WALL ST. J., Jan. 27, 1997, at A22.

25. For recent examples, *see In re* A.H. Robins Co. Inc., 182 B.R. 128, *aff'd* 86 F.3d 364, 376-78 (4th Cir. 1996) (disallowing a fee exceeding 10% of the recovery on the ground that it would deprive the claimants of their full and just recoveries); Brenda Sapino Jeffreys, *Pipe Dream Shattered by Big Fee Cut*, Texas Lawyer, Nov. 25, 1996, at 1 (court disal-

The judicial impulse behind these methods is sound; courts properly recognize that counsel's fee in the settlement must be policed, or else counsel will be tempted to strike a bargain with the defendant in which counsel is paid a lot and the class is paid relatively little in settlement.[26] Allowing a proposed fee that flunks one or both of the above tests would enable counsel and the defendant to strike such a bargain. However, the tests provide incomplete protection against settlements that give the class too little. In particular, a proposed fee may pass both of the above tests, while nonetheless making possible a settlement that gives the class only a tiny fraction of the value of its claims.

The example used above illustrates the point. In case (*b*), assume that the court allows class counsel a fee that gives him a profit equal to five percent of the class's recovery. Anticipating that fee, the counsel may agree to a settlement giving the class as little as $2 million.[27] From a purely distributional point of view, giving him a profit equal to five percent of that recovery may be perfectly reasonable. Many courts would undoubtedly think so.[28] In addition, the profit that he earns in this settlement may seem quite reasonable in relation to the amount of time he has put into the case.[29] Thus, the fee in this example might well be approved under both judicial tests—so that counsel will indeed be willing to settle the case for a tiny fraction of the $100 million it is worth to the class.

Neither test, then, necessarily gives counsel an incentive to reject settlement offers that give the class members less than the value of their claims. The basic problem with both tests is that they view the lawyer's fee exclusively in the context of the settlement, without asking what the lawyer would have gotten had he not negotiated the settlement. That is, they look at the lawyer's share of (or profit from) the settlement in *absolute* terms, rather than *relative* to what would have

lows proposed fee giving class counsel twice the amount received by class members in settlement).

26. The defendant will go along with such an arrangement as long as its total payment in the settlement is less than its expected liability at trial.

27. *See supra* note 22.

28. Many studies have shown that fee awards in class actions generally amount to between 20% and 30% of the class recovery. *See, e.g.*, sources cited *supra* note 9. While this represents a gross figure (not net of the counsel's costs), it is fair to conjecture that the resulting profit may exceed 5% of the amount taken home by the class members.

29. We have not specified in the example how much time counsel has put into the case, or what the opportunity cost of his time is. It is not difficult to imagine scenarios in which a profit of $100,000 for negotiating a classwide settlement would, in the eyes of many courts, be considered reasonable in relation to the amount of time spent on the case.

happened at trial. A fee that looks quite reasonable in absolute terms may be much too high in relative terms, thus giving the counsel an incentive to settle for far less than the case is worth to the class. To prevent this, the court must equalize the lawyer's relative shares in and out of settlement. The following sections attempt to justify and apply this basic principle.

III. A Framework For Analysis

A. The Setting

To analyze the problem of settlement regulation, we will use the following simple model of a class action. Assume that a group of plaintiffs have brought suit seeking monetary relief against a defendant. A particular class counsel, representing (or hoping to represent) the plaintiffs, negotiates a settlement with the defendant that would extinguish all of the plaintiffs' claims. The court is called upon to approve the settlement. As part of the approval process, the court can determine what fee class counsel may recover as part of the settlement.

Who is class counsel? There are a number of possibilities, depending on the precise posture of the case. If the court has certified a class for purposes of trial, then class counsel may be the person (or firm) whom the court has designated as lead counsel in the case. Alternatively, class counsel may be a lawyer who has been retained by some fraction of the plaintiffs, and is hoping—by negotiating a class-wide settlement—to "leverage" himself into the position of class counsel. We will consider these and several other possibilities in our analysis.

B. The Court's Objective

We assume that the court's objective in setting counsel's fee is to ensure that counsel settles the case if and only if the resulting settlement makes the class better off than not settling.[30] Thus, suppose that $100 million is the amount that the class would collect, in expected terms, if there were no class settlement. The court wants to ensure that class counsel will reject a settlement that gives the class less than $100 million, but will accept a settlement that gives the class at least $100 million. This is what reasonable class members themselves

30. This is the standard formulation of the court's task in acting as the class members' guardian for purposes of reviewing the settlement. *See, e.g.*, Manual for Complex Litigation § 30.42 (3d ed. 1995); Morawetz, *supra* note 2, at 11 (citing cases).

would do, if they could effectively control the settlement decision.[31] The court's objective is, in essence, to induce the counsel to make the decision the class would want him to make.

Two points should be noted about this formulation of the court's objective. First, we are viewing the court's problem in principal-agent terms; that is, we want to encourage the counsel to act in the class's interests, as those interests are established by the background legal regime. I take the value of the class's claims as given, or exogenously fixed. Thus, if the plaintiffs would recover an expected amount of $100 million were there no class settlement, I assume that they should recover that much in any class-wide settlement. Whether $100 million is the "right" amount in any other sense (apart from being the amount the background legal system gives the plaintiffs) is obviously an important question, but it is not one that I consider here.

Second, I make no assumptions about the procedure that is followed if there is no class settlement. In some cases, there will be a class-wide trial. In other cases, individual plaintiffs' cases will be resolved separately (either in individual trials or individual settlements). This makes no difference for our purposes. We simply want to ensure that the plaintiffs fare at least as well in a class-wide settlement as they would if there were no class-wide settlement.

C. Constraints

To bring into focus the problem of setting the fee correctly, we assume the court is acting under three constraints: (1) the class members lack effective control of the class counsel's settlement decision, and may not be able to opt out of a settlement that gives them less than the value of their claims;[32] (2) the court is uncertain about, and

31. Notice that we are treating the class as a unitary entity here. We do not address the problem of distributing the recovery among the class members, or (more broadly) of resolving the conflicting interests of class members. These are important problems; but an equally important, and logically prior, problem is to ensure that the class as a whole recovers the value of its claims. (There is no way to ensure that *each* class member receives the value of her claims if the class as a whole does not recover the full value of its claims.) On problems of distribution and conflicting interests within the class, see John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987); Deborah L. Rhode, *Class Conflicts in Class Actions*, 34 STAN. L. REV. 1183 (1982); Morawetz, *supra* note 2.

32. Plaintiffs may, for example, lack the information to intelligently exercise the right of opting out.

tends to underestimate, the value of the class's claims;[33] and (3) class counsel acts to maximize his own return from the case.

Setting the fee correctly is most important when these assumptions hold. In cases where any of these assumptions does not hold, there is little risk that the counsel will settle the case for too little.[34] Obviously the extent to which these assumptions hold will vary from case to case. It is reasonable to suppose, however, that these assumptions hold to some extent in many cases.[35] To that extent, there is a real risk that class counsel will settle the case for too little unless he is given appropriate incentives.

IV. The Importance Of Equalizing Relative Shares

A. Counsel's Settlement Decision

Suppose that class counsel is considering whether to enter into a class-wide settlement with the defendant. His financial motivation is to agree to any settlement that will give him at least as much as he would get were he *not* to negotiate a class-wide settlement. In deciding whether to accept a given settlement amount on behalf of the class, therefore, he will want to know what his effective share of that settlement amount will be, and how that share compares to what he would get if he walked away from the bargaining table. To analyze this decision, we will initially assume that there is only one class counsel with authority to negotiate on behalf of the class.[36]

To examine the counsel's settlement decision, it is helpful to use some simple notation. Let us assume that if class counsel negotiates a class-wide settlement, he gets a net profit of

$$\alpha A,$$

33. Having entered into a settlement, the settling parties—the defendant and the class counsel—have an incentive to overstate the value of the settlement relative to the value of the class's claims, in order to secure judicial approval of the settlement. (Objectors to the settlement may counteract this tendency to some extent.)

34. If the class members could effectively control the class counsel (perhaps by opting out of a settlement), they would veto any settlement that gave them less than the value of their claims. If the court knew the value of the class's claims, it would refuse to approve any settlement giving the class less than that. If the class counsel were interested in maximizing the class's return from the case (rather than his own), he would refuse to settle for less than the value of its claims.

35. Students of the class action generally agree that these constraints are present in many class action settings. *See, e.g.*, Coffee, *supra* note 1; Macey & Miller, *supra* note 1.

36. We thus put to one side for the moment the possibility of competition among different lawyers to be the class representative in the settlement negotiations. We do this for clarity of exposition; as we will see, our conclusions do not change if we relax this assumption.

where

A = Net amount paid to the class if class counsel negotiates a settlement;

α = Fraction of A that class counsel collects as his net fee if he negotiates a settlement.

Note that α represents class counsel's fraction of the class's recovery *net of his costs*. Note, in addition, that A represents the amount paid to the class after class counsel has been paid his attorney's fee.[37]

Now suppose that class counsel does not negotiate a class-wide settlement (he instead "walks away" from the negotiations). As a result, he gets a net profit of

$$\beta B,$$

where

B = Net amount paid to the plaintiffs if there is no class-wide settlement;

β = Fraction of B that class counsel collects as his net fee if there is no class-wide settlement.

Using this notation, we see that class counsel will accept any settlement amount A if the following inequality is satisfied:

$$\alpha A \geq \beta B \quad (1)$$

The left-hand side indicates class counsel's profit if he accepts the settlement; the right-hand side indicates his profits if he walks away from the bargaining table.

B. The Court's Task

The court seeks to ensure that class counsel does not settle the case for less than it is worth to the class members. More precisely, the court wants to ensure that A, the amount collected by the class in settlement, is at least as great as B, the amount that the plaintiffs would have gotten had there been no class-wide settlement. To accomplish this, it must choose the value of α—the net share of the settlement—that it will permit the class counsel to collect. It is straightforward to see that the court should choose the value of α that satisfies the expression

$$\alpha = \beta. \quad (2)$$

37. Thus, to give a simple example: suppose that the defendant pays a total of $100 million to settle the case; suppose that class counsel collects $15 million of this as his fee; and suppose the costs he has incurred are $9 million. Then A = $100 million - $15 million = $85 million; and α = ($15 million - $9 million)/$85 million = 7%.

That is, counsel's share of settlement should be the same as his share of the plaintiffs' recovery if there were no settlement. This ensures that class counsel's "bottom line" for settling—the minimum amount for which he will settle the case—will be equal to B. To see this, observe that—as we know from expression (1)—the minimum amount (the minimum value of A) the lawyer will accept in settlement is given by[38]

$$\frac{\beta}{\alpha} B$$

As inspection makes clear, this expression is as large as B if and only if β is as large as α; and the expression is equal to B when $\alpha = \beta$. If α is greater than β, then the lawyer's bottom line for settling will be less than B. (Notice, moreover, that if α is too great by a given factor, the settlement the lawyer will accept will be too small by that same factor. So for example, if α is twice as great as β, the lawyer will settle the case for an amount equal to half of B.)

The court's problem, then, is to make α no greater than β. The practical implication of this prescription is as follows: suppose that class counsel negotiates a class-wide settlement that the court is tempted to approve (because the court believes, given its limited information, that it gives the class members the value of their claims). Upon approving the settlement, the court should award class counsel a fee that, in net terms, gives class counsel a share of the settlement equal to the share of the class's recovery he would have gotten if there had been no class-wide settlement.

The effect of doing this is to give class counsel a penalty for negotiating a settlement that is too small. If, notwithstanding the court's belief to the contrary, the settlement gives the class members less than the value of their claims, then class counsel will wind up getting less than he would have gotten if he had not negotiated the settlement. Knowing this, class counsel will decline to agree to such a settlement. This approach, ex ante, encourages class counsel to reject any settlement that gives the class less than the value of their claims, while encouraging him to accept any settlement that gives them at least the value of their claims.

38. Rearranging terms in the expression $\alpha A < \beta B$ yields the expression in the text.

C. The Possibility of Rival Settlements

To this point in the discussion, we have assumed that only a single lawyer (or group) has authority to negotiate a class settlement, so that there is no competition among different lawyers to be the one who negotiates the settlement. Let us now drop this assumption. Suppose that the defendant can negotiate simultaneously with several different lawyers, and enter into a classwide settlement with the one who offers the most favorable terms.[39] (Note that the *possibility* of such "shopping" might affect the terms of settlement, even if such shopping is not observed in practice.)[40] How does this affect the analysis?

In general, the analysis that I have developed remains valid in this setting. The court's task is to ensure that for each lawyer seeking to negotiate a classwide settlement, the following is true: his net share of a settlement he negotiates is no greater than the share he would get of the plaintiffs' recovery if he did not negotiate a classwide settlement. If that condition holds, then no lawyer will have any incentive to underbid any other lawyer in seeking to settle the case. In addition, no lawyer will have any incentive to settle for less than the amount that the class would receive were there no class-wide settlement at all.

I can make the point more precise as follows. Let χ denote the net share the class counsel would have gotten if another lawyer had negotiated a classwide settlement.[41] Then the court should set α equal to the lesser of β and χ.[42] If it achieves this, then the court ensures that the case will settle for at least the value of the class members' claims.[43]

39. Several commentators have argued that this leads to a sort of reverse auction in which rival lawyers seek to underbid one another. *See, e.g.*, Coffee, *supra* note 2.

40. In this respect the situation is no different from any other market. For example, a given consumer may not generally shop among different grocery stores to find the best price for a given item. But the fact that he *can* do so exerts downward pressure on prices; each store charges less than it would if it were the only store in town. Thus, even though one might observe no comparison shopping in practice, the possibility of comparison shopping yields very different prices than would obtain if no such shopping were possible.

41. Thus, for example, suppose that class counsel's profit if another lawyer had negotiated a class settlement would have been equal to 1/10 of the net amount received by the class. Then $\chi = 1/10$.

42. For a formal demonstration, see Hay, *supra* note 15.

43. To illustrate the point, suppose that there are two lawyers who might (independently) negotiate a classwide settlement with the defendant; call them Smith and Jones. Consider Smith's decision of how much to settle the case for. Assume that α is no greater than either β or χ. Then Smith has no incentive to settle the case for less than it is worth to the class: if Jones makes a settlement offer, Smith will not want to undercut it (no matter what it is); and if Jones makes no settlement offer at all, Smith will refuse to settle the case

Now, in general, there is no reason to suppose that for a given lawyer α is smaller than β. In other words, it seems reasonable to assume that his share of a settlement negotiated by another attorney is as large as his share of what the plaintiffs would get were there no class-wide settlement.[44] Granted this assumption, the court's problem boils down to ensuring that α is no larger than β.[45] In the remainder of our analysis, therefore, we will focus on the task of making α equal to β—that is, making class counsel's effective share of a settlement that he negotiates equal to his effective share of what the plaintiffs would have recovered were there no class settlement at all.

V. Two Sources Of Asymmetry

Why might the class counsel's share of a settlement be too large? More precisely, why might α, his effective share of a class settlement he negotiates, be greater than β, his share of what the plaintiffs would have gotten in the absence of a class settlement? In this part, I examine two basic reasons why this might plausibly occur. In essence, my purpose is to show how a conscientious court might inadvertently give class counsel an incentive to settle the case for less than it is worth to the class members.

To examine this issue, we will use a series of examples based on our hypothetical case involving 1,000 plaintiffs, the aggregate value of whose claims is $100 million.[46] I do not claim that these examples are representative of actual judicial practice. My point is to illustrate the risk that a court might unwittingly encourage class counsel to settle the case for much less than it is worth to the class.

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for less than B. Thus, no matter what Jones does, Smith will not offer to settle the case for less than it is worth to the class.

However, if α is greater than either β or χ, then Smith may rationally choose to settle the case for less than it is worth to the class. We have already seen why this is true if α is greater than β; let us therefore examine why it is also true if α is greater than χ. Suppose that Jones offers to settle the case for an amount that gives the class members an amount equal to B, the value of their claims. Smith has an incentive to undercut this offer, since—α being greater than χ—he wants to be the one who negotiates the settlement. To prevent this kind of downward bidding, the court must ensure that α is no greater than χ.

44. A lawyer's contract with his clients will normally give him a fee even if some other lawyer negotiates a classwide settlement. There is no obvious reason to suppose that this fee would be smaller (expressed as a net fraction of the client's recovery) than the fee he would earn if there were no classwide settlement.

45. In doing so, the court automatically ensures that α is no larger than χ.

46. That is, B = $100 million.

A. Disproportionate Client Bases

The first source of error arises when the class counsel's client base is larger when he negotiates a classwide settlement than when he does not. For example, assume that class counsel gets a net share of ten percent of the recovery obtained by each plaintiff he represents, regardless of whether he negotiates a class settlement. Assume that if he negotiates a classwide settlement he will collect this fraction of each plaintiff's recovery. Assume, however, that if he does *not* negotiate a classwide settlement he will only represent *half* of the plaintiffs in the class. Then his effective share of the overall recovery by the class (if there is no class settlement) is only five percent. In contrast, his effective share of the overall recovery by the class if he negotiates a classwide settlement will be ten percent. As a result, he will have an incentive to settle the case for half of what it is worth to the class.

How might such an asymmetric reward structure arise? Consider two scenarios.

(1) Settlement Class Actions

One possibility is that the class has not been certified for purposes of trial. In such a setting, typically different groups of plaintiffs are represented by different lawyers (or firms). If there is no classwide settlement, then no single lawyer will represent more than a fraction of the plaintiffs in the ensuing proceedings. As a consequence, class counsel will represent many more plaintiffs if he negotiates a class settlement than otherwise.

A particularly vivid example of this occurs when the class settlement includes claims for future injuries. The owners of these claims have not yet brought suit and (if there is no class settlement) may not do so for many years. Class counsel has no reason to suppose that when they do bring suit in the future, they will hire him rather than some other lawyer. In negotiating a class settlement that includes these claims, class counsel thus has a larger client base.

(2) Trial Class Actions

Even if the case involves a class (to be) certified for trial, asymmetric rewards may arise if there is uncertainty about who will be class counsel at trial. Consider the following scenario in our hypothetical case: class counsel files suit in California and obtains a nationwide class certification; lawyer *Y* does the same in Texas. No one knows which of these rival suits will go to trial first (or, if they are consolidated, in what state they will be consolidated); and assume that each

has a 50/50 chance of being the first to go to trial. The first suit to go to trial will preclude trial in the other because of res judicata.

In this setting class counsel will, in expected terms, represent only half of the class if the case goes to trial. His effective share of the class's trial recovery will, accordingly, be only half of what it would be if he were certain to be class counsel at trial. Thus, for example, if his effective share of the class's trial recovery is ten percent in the event he is class counsel at trial (and zero otherwise), then his expected share is only five percent of that recovery.

B. Disproportionate Per-Claim Shares

The second type of error that a court might commit arises when counsel represents the same number of plaintiffs whether or not he negotiates a classwide settlement, but gets a larger share of each claim if he negotiates a classwide settlement. For example, suppose that class counsel will represent the whole class whether or not he negotiates a classwide settlement. Assume that if the case goes to trial, he will get a net expected fee equal to five percent of the class recovery. But if he negotiates a classwide settlement, he will get a net fee equal to ten percent of the class recovery. Given such asymmetric rewards, he will be willing to agree to a settlement that gives the class only $50 million.

How might such an asymmetry arise? Consider two possible scenarios.

(1) Input-Based Fee Awards

One possibility is that the court calculates the counsel's fee on a basis other than percentage-of-the-award. If, for example, the court pays the counsel an hourly fee under the so-called "lodestar" approach,[47] it might unwittingly give the counsel too large a share of a settlement he negotiates.

Let me give a simple example. Suppose that if the case goes to trial, the class has a 50/50 chance of winning, and if the class wins then class counsel will earn a profit of $10 million. Suppose, in contrast, that the court will approve any settlement that gives the class at least

47. In essence, this approach has the court determine the number of hours (reasonably) spent on the case, and then multiply the result by the hourly fee for similar services in the market. This method has received widespread judicial use in the past 25 years. *See, e.g.*, NEWBERG & CONTE, *supra* note 9, at 34-36 (collecting cases).

$50 million, and that if class counsel negotiates such a settlement, he will earn a profit of $5 million.[48]

The basic problem is that class counsel's fee is not (fully) tied to the amount he recovers for the class.[49] As a result, he is in effect overpaid for settling the case; his net profit (after subtracting the costs of his efforts) is greater if he settles for $50 million than if he takes the case to trial. The reason this occurs is that his effective share of the settlement is, in expected terms, greater than his effective share of the trial proceeds.[50] The problem would not arise if the court adjusted class counsel's settlement fee so as to ensure that the effective shares were the same.[51]

(2) Output-Based Awards

Even if the court employs a percentage-of-the-award formula to compensate class counsel,[52] the problem of asymmetric rewards may arise if the fee award does not properly reflect the differential in the costs of going to trial and the costs of settling.[53] Suppose, for example, that if the case goes to trial class counsel will incur $7 million in costs; and that if he wins he will get ten percent of the recovery as his fee. Suppose, in addition, that if the case settles he will incur $1 million in costs, and get eight percent of the recovery. In this scenario, he will be willing to settle the case for $50 million.[54]

In this example, class counsel's *nominal* share of a settlement (before costs are subtracted) is smaller than his nominal share of trial proceeds. Once costs are subtracted, however, his *effective* share of a settlement is greater than his effective share of trial proceeds. As a result, he is willing to settle the case for too little.

48. We assume here that going to trial is no more costly to counsel than settling. The point holds with still greater force if this assumption does not hold.

49. Others have noted that this feature of input-based awards makes the class counsel willing to settle for a relatively small amount. *See, e.g.*, Coffee, *supra* note 1, at 717-18.

50. His effective share of the trial proceeds is 5%. His effective share of the settlement is 10%.

51. If class counsel received only 5% of any settlement, he would not settle for less than $100 million.

52. A percentage-of-the-award approach, once predominant among courts, fell out of favor in the 1970s but has received increasing use in the past decade. *See* NEWBERG & CONTE, *supra* note 9, at 40-50 (collecting cases).

53. This problem has long been recognized. *See* Saylor v. Lindsley, 456 F.2d 896, 900-01 (2d Cir. 1972); Dam, *supra* note 1, at 56-58; Macey & Miller, *supra* note 1, at 25; Jack B. Weinstein, *Ethical Dilemmas in Mass Tort Litigation*, 88 NW. U. L. REV. 469, 524-25 (1994).

54. His expected profit from going to trial is (.1)(100 million) - 7 million = 3 million. Settling for 50 million gives him (.08)(50 million) - 1 million = 3 million.

C. The Impact of Asymmetric Rewards

How important are these sources of asymmetry? How much turns on eliminating them? Potentially, quite a bit. Table 1 illustrates the point. The table indicates the value of *A/B* (the ratio of the amount demanded in settlement to the value of the claims) in a sample set of hypothetical cases. The left-hand column in the table captures the first source of asymmetry—unequal client bases: this column refers to the fraction of the class the counsel would represent if he did not negotiate a classwide settlement. The top row in the table captures the second source of asymmetry—greater per-claim shares: this row refers to the differential (expressed as a multiple) between the per-claim share he gets if he negotiates a classwide settlement and the per-claim share he gets otherwise.[55]

Table 1
Effect of Asymmetric Rewards on the Amount Recovered by the Class in Settlement

Fraction of class lawyer would otherwise represent	Per-claim share multiple		
	1x	2x	5x
1	*A/B* = 1	*A/B* = .5	*A/B* = .2
1/10	= .1	= .05	= .02
1/100	= .01	= .005	= .002

As the table indicates, if either of these asymmetries is present, the ratio *A/B* is less than one: that is, the class counsel has an incentive to settle the case for less than its value to the class. If either type of asymmetry is substantial, the distortion in the counsel's incentives may be enormous. Consider, for example, the center entry in the table: if the counsel would otherwise represent only one-tenth of the class members, and would otherwise earn twice as much per claim, then he will be prepared to settle the case for a mere five percent of what it is worth to the class!

VI. The Mechanics Of Equalizing Effective Shares

A. Structure of the Optimal Fee

I turn now to implementing the judicial task as I have described it. How does the court regulate the class counsel's fee in such a way as

55. Thus, "2x" means that the per-claim share he gets in a classwide settlement that he negotiates is twice as great as the per-claim share that he gets otherwise.

to avoid the problem of asymmetric shares? In practical terms, the court needs to know how much money the class counsel should be able to collect from the defendant. Our task here, therefore, is to convert the notion of symmetric shares into a dollar amount. We will use the following notation:

a = Fraction of the class's settlement recovery that the class counsel is allowed to take as his fee ($1 > a > 0$).

Thus, for example, if $a = 1/10$, the court would permit the class counsel to take an amount equal to 1/10 of the amount paid to the class.[56]

The court's task is to choose an appropriate value of a. Its objective is to ensure that A, the net amount recovered by the class in settlement, is at least as large as B, the expected amount recovered by the plaintiffs if there is no class settlement. The constraint on the court's action is that the class counsel will accept any settlement that gives him at least as much as he would receive were there no class settlement at all.[57] The solution to the court's problem is as follows:[58]

$$a^* = b + \frac{X}{B} \qquad (3)$$

where

a^* = The appropriate class counsel fee to be determined by the court.

b = Fraction of the plaintiffs' recovery that the class counsel would have collected as his fee had there been no class-wide settlement ($1 > b > 0$).

X = Additional costs that class counsel incurs as a result of negotiating and/or implementing a class-wide settlement.

Let us briefly describe the components of expression (3).

(1) Fractional Share of Class Recovery Outside of Settlement (b)

The b term represents the fraction of the plaintiffs' recovery the class counsel would have gotten if there had been no class settlement. This fraction may be extremely small. For example, suppose that if there had been no class settlement, the class counsel would only have represented 1/1,000 of the plaintiffs; and suppose his fee on each claim

56. Note that a represents the class counsel's *gross* fractional share of the settlement, whereas our earlier term α represented his fractional share *net of his litigation costs.*

57. For expositional clarity, we ignore the possibility that some other lawyer will enter into a class settlement. The analysis here can be adjusted straightforwardly to take account of that complication.

58. *See* Appendix for a derivation.

would have been one-third of the recovery. Then b would be equal to 1/3,000, or .00033.

(2) Additional Costs Incurred in Settlement (X)

The X term represents the additional costs incurred by the class counsel in negotiating and implementing a class settlement—over and above what he would have incurred had there been no classwide settlement.[59] Observe that X may be positive or negative. In some settings, negotiating a classwide settlement generates greater costs for the class counsel than he would incur otherwise.[60] In others, negotiating a classwide settlement actually saves him costs.

(3) The Class Members' Expected Recovery (B)

The B term represents the net amount the class would recover, in expected terms were there no class settlement. This is the amount that the court seeks for the class members to receive in the class settlement.

B. The Problem of Judicial Error

Our derivation of the optimal fee raises an obvious difficulty. To accurately evaluate expression (3), a court needs to know the value of B, the class's expected recovery were there no class settlement. But a fundamental premise of our analysis is that the court does not know the value of this term. Of what help is our derivation of the optimal fee if it requires knowledge that the court lacks?

The answer is that effective regulation of the counsel's fee does not require the court to accurately assess expression (3). Even with an imperfect estimate of the value of B, the court may profitably use expression (3) to regulate the class counsel's fee. In particular, even if the court underestimates the value of B in assessing expression (3), the class is likely to benefit if the court (despite the error) regulates the counsel's fee in accordance with the above analysis.

I can state the point more precisely as follows. Suppose that the court underestimates the value of B by a factor of two. Assume that the court uses this erroneous estimate in regulating the counsel's fee.[61]

59. Thus, suppose that class counsel spends 100 in negotiating the class settlement. If he would have spent 75 had there been no class settlement, then $X = 25$. If he would have spent 150 had there been no class settlement, then $X = -50$.

60. This might be true, for example, when the counsel's fractional share of the clients in the class is very small.

61. We assume here that the court accurately assesses the other terms in (3).

If it does so, the class's recovery in settlement will *not* be too small by a factor of two. Rather, the class's recovery will be larger than that. Indeed, it may be very close to the right amount. In other words, court error of a given magnitude in estimating the value of B does not translate into a shortfall of the same magnitude in the class's recovery.

The basic insight here is that the court can (with reasonable accuracy) equalize the attorney's relative shares even if it does not know the value of B. This point may be seen most easily by assuming (to take the simplest case) that the value of X is zero.[62] Then the court's estimate of the value of B is irrelevant, as inspection of (3) quickly reveals.[63] Even if the court's estimate of B is off by a huge margin, the court can equalize the class counsel's relative shares. More generally, even when X is not zero, the court can—in spite an erroneous estimate of B—come close to equalizing the counsel's relative shares.

Let me give a numerical illustration, drawing again on our earlier example. Let us assume that the value of the class's claims is $100 million, that class counsel will earn five percent of that amount as his fee if there is no class settlement, and that negotiating a classwide settlement costs the class counsel an additional $500,000.[64] Table 2 indicates the amount that the class recovers in settlement, given that the court underestimates the value of B in setting the counsel's fee.[65] The left-hand column states the extent to which the court underestimates the value of B.[66] The right-hand column states the fraction of B for which the counsel is willing to settle the case, given the fee that the court allows.[67] Observe that the entries in the right-hand column of Table 2 are greater than the corresponding entries in the left-hand column. This result is not specific to the example we have chosen: no matter what the numbers in the example are, the right-hand column will always be greater than the left-hand column.

62. That is, negotiating a classwide settlement costs the class counsel neither more nor less than what he would incur were there no class-wide settlement.

63. The value of a^* is simply given by b.

64. Thus, B = $100 million, b = .05, and X = $500,000.

65. The Appendix gives the formula for deriving the results in Table 2.

66. Thus, a value of .9 means that the court estimates the value of B to be .9($100 million), or $90 million.

67. More precisely, the right-hand column indicates the minimum fraction of B that the class will recover in settlement.

Table 2
Effect of Judicial Error in Setting the Fee

Court's estimation of the value of B (expressed as a fraction of the actual value of B)	Fraction of B recovered by the class in settlement
.9	.99
.75	.97
.5	.92
.25	.79
.1	.55

Now, in this discussion we have implicitly assumed that the court can accurately assess the b and X terms in expression (3). This assumption is not essential to the analysis. All that matters is that errors in the court's estimation of these terms be unbiased—that is (roughly speaking), that an underestimate be neither more nor less likely than an overestimate of these terms.[68] If this condition obtains, then the class counsel—unsure of which type of error will occur in his own case[69]—will act in the same fashion as he would if the court could accurately assess the terms. Our basic result—that the right-hand column in Table 2 is greater than the left-hand column—will then obtain.

This point should not be overstated. It may be that the court systematically overestimates the value of b and X, while at the same time underestimating the value of B.[70] If so, then the foregoing conclusion does not hold: if the judicial error is sufficiently great, then the right-hand column of Table 2 will not necessarily be greater than the left-hand column.[71] This possibility does not, however, diminish our central claim in this section; namely, that effective fee regulation in accordance with expression (3) is possible even though the court cannot accurately assess the value of B.

C. Fee Calculation Methods

Expression (3) should be understood to impose an upper bound on the fee collected by class counsel. Employment of this analysis

68. More precisely, what matters is that the mean of the distribution of possible court estimates of the terms be equal to the true value of the terms.

69. We assume that the court sets the fee after the settlement is entered into.

70. The settling parties have an incentive to induce the court to overestimate the values of b and X, since this will enhance the counsel's fee (making it in the counsel's interest) and lead the counsel to demand less in settlement (making it in the defendant's interest).

71. Conversely, if the court systematically underestimates b or X, it may set the fee too low, thereby raising the counsel's minimum settlement demand to a point so high that the defendant is unwilling to settle.

does not (apart from creating this ceiling) require the court to use any particular fee-calculation method in determining the amount the class counsel should recover for negotiating a class settlement. The court can employ a "lodestar" hourly-fee approach, a percentage-of-the-recovery approach, or some other approach. All that matters is that the amount recovered by class counsel not exceed the amount prescribed by expression (3).[72] That is, under whatever fee-calculation method the court employs, the court should determine the fraction of the class's recovery that the counsel is receiving, and ensure (to the extent possible) that this fraction satisfies expression (3).

Conclusion

The prescriptions of this essay are intended to supplement, not displace, existing methods of policing the terms of class action settlements. Faced with a proposed class action settlement, the court can—without conflicting with the prescriptions here—examine the terms of the settlement, hold hearings, and reject the settlement if it concludes that the settlement gives the class less than the value of their claims. This type of direct regulation of the settlement agreement is fully consistent with the approach proposed here. Indeed, as we have seen, the approach proposed here requires the court to estimate the value of the class's claims.[73]

In addition to undertaking such direct regulation, however, the analysis in this essay suggests that the court should employ the indirect method of adjusting the class counsel's settlement incentives. By structuring the fee so as to eliminate asymmetric rewards, the court creates a type of safety net to protect against the risk that it will underestimate the value of the class's claims. The class generally does better in settlement if the court attempts to adjust the counsel's incentives in this manner, rather than simply relying (in direct regulation) on its own error-prone estimate of the value of the class's claims.[74]

The main respect in which the prescriptions of this essay depart from existing practice is in the courts' approach to policing the class counsel's fee in class settlements. As we have seen, our analysis does

72. This implies, of course, that the counsel must be precluded from accepting any side-payments (other than the fee award) from the defendant in exchange for settling the case.

73. Evaluating expression (3) requires the court to estimate the value of *B*.

74. If the court relies on direct regulation alone, the class gets (to return to our earlier example) the left-hand column of Table 2. If the court relies on both direct and indirect regulation, the class gets either the left- or right-hand column, whichever is greater; and as we saw above, the right-hand side will generally be greater.

not require the court to employ any particular method of fee calculation. The analysis does show, however, that under whatever fee-calculation method it employs, the court must check to ensure that it is not creating an asymmetric-reward structure that encourages class counsel to settle the case for less than the case is worth to the class members. Adoption of the approach suggested in this essay would go far in allaying the concern that under existing practice, class actions settle for too little.

Appendix

In this Appendix we derive the results presented in Part VI above. Define the following notation:

A = the amount received by the class (net of the fee paid to class counsel) in a classwide settlement negotiated by class counsel;
a = the fraction of A the class counsel is allowed to take as his fee ($1>a>0$);
B = the net total expected recovery by the plaintiffs if there had been no classwide settlement;
b = the fraction of B the class counsel would have collected as his fee if there had been no classwide settlement ($1 > b > 0$);
X = Additional costs class counsel incurs as a result of negotiating a classwide settlement.[75]

A. Deriving the Optimal Fee

The court wants to find the value of a satisfying

$$A = B, \tag{A1}$$

subject to the constraint that the class counsel will settle for any amount satisfying

$$\alpha A - X = bB. \tag{A2}$$

Solving for A in (A2) yields

$$A = \frac{bB + X}{\alpha} \tag{A3}$$

Plugging (A3) into (A1) and solving for a yields

$$a^* = \frac{bB + X}{B} \tag{A4}$$

B. Effect of Judicial Error

Assume the court's estimate of B is equal to λB, where λ represents an error term. If the court employs this estimate in setting the fee, we have

$$a = \frac{b\lambda B + X}{\lambda B} \tag{A5}$$

75. That is, over and above what he would have incurred had there been no classwide settlement.

Plugging this into (A3) and solving for A gives

$$A = \frac{(bB + X)\lambda B}{b\lambda B + X} \tag{A6}$$

Simple algebra establishes that (A6) is greater than λB anytime λ is less than one.